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VOL. CLIII NO. 67 Wednesday, April 6, 1988 153rd Year

Today

California is now a major EFT state; ATM network services are ubiquitous, and POS debit systems are running in several retailing chains. —2

First Boston Corp. was still No.1 underwriter of asset-backed securities in the first quarter, as the market's new-issue volume jumped almost threefold from the same period in 1987. Issuance, however, plunged more than 36% from the fourth quarter of last year. —2

Shearson Lehman Hutton Inc. closed a $29 million private placement of securities backed by mortgages on time-share vacation units. The mortgages were sold by Glen Ivy Resorts, a California time-share developer. 2

Exclusive rights to market MasterCard credit cards to fans of the New York Yankees have gone to Marine Midland Bank. —3

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COMMENT

Bank failures will continue at the same pace through 1988, whether or not one includes banks receiving FDIC assistance, says Irvine H. Sprague. —4

The annual "Statistical Abstract of the United States" spotlights social and economic trends — from the indispensable to the trivial — writes Robert J. Samuelson. —5

TECHNOLOGY

Paperless payments will be easier for banks and corporations to initiate with the personal computer products introduced at the National Automated Clearing House Association annual conference. —8

A miniaturized microfilming machine meets bankers' growing preference for filming checks in their branches. The unit, introduced by Eastman Kodak Co., is called a desktop microfilmer and fits in a 19-by-23-inch area. —8

The Federal Communications Commission intends to drop a proposed minimum access fee for those who use interstate telephone lines for computer communications. The proposed fee would have cost banks nearly $250,000 per year. —9

Arthur Andersen & Co. has introduced a software package to help large banks and businesses write their own application programs. — 11

Littlewood, Shain & Co. has joined Info-Mation Systems, a Texas software development firm, to form LSC Payment Systems. — 12

Worth Repeating

We're getting lots of money lately, and I think much of it's been from First Republic.

Les Mckee, a vice president at Dallas Teachers Credit Union, Dallas. [Page 1]

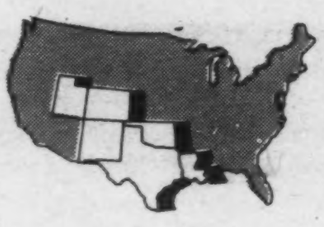
FROM THE REGIONS

THE SOUTHWEST

Credit Unions Prosper in Texas Slump

By DAVID LaGESSE
Southwest Bureau

DALLAS — Amid the confusion of the state's bank failures and thrift fraud, credit unions in Texas have calmly gone about the business of making consumer loans — and profits.



The state's 1,000-plus credit unions, in fact, have turned in a "stellar performance" in light of the state's economic problems, according to the nation's chief regulator of credit unions, Roger Jepsen, who will praise the Texas industry in a speech in Houston later this week.

Generally much smaller than banks and thrifts, credit unions usually stick to consumer lending — automobiles, boats, home equity. In Texas, they have avoided the oil and real estate lending that is now sinking the state's banks and thrifts. Credit unions are limited to defined customer bases, such as employees of a certain company, which provide more stable banking relationships.

Last year, the state's 280 thrifts reported losses of more than $6 billion, and its 1,900 banks lost more than $1 billion. State-chartered credit unions in Texas, which number about 400, earned an average return on assets of about 0.7%, according to the Texas Department of Credit Unions.

Perhaps most impressive, the state's

From the Regions: Page 22 ➡

Interest Rate Swaps Outstanding

Dollar amounts in billions of notional value

	12/31/87	6/30/87	12/31/86
1. Citibank	$117.5	$90.8	$66.1
2. Chemical Bank	95.0	67.3	35.5
3. Chase Manhattan Bank[1]	94.6	40.1	21.9
4. Bankers Trust Co.	82.6	66.8	51.6
5. Manufacturers Hanover Trust Co.	70.2	52.6	38.0
6. Morgan Guaranty Trust Co.	58.5	50.8	40.2
7. Security Pacific National Bank	39.7	28.5	14.9
8. First National Bank of Chicago	21.5	19.4	17.7
9. Bank of America	18.6	14.5	11.5
10. First Interstate Bank of California	18.1	13.9	11.3

[1]Chase Manhattan's yearend 1987 number for outstanding swaps is the only one to include forward rate agreements, interest rate caps, and interest rate floors booked during the fourth quarter.

Source: Bank call reports, compiled by *American Banker*.

An American Banker Special Report

Bankers Cite Edge over Rivals In Competitive Swaps Market

By LISABETH WEINER
Third of a Series

CHICAGO — With outstandings hovering at about $1 trillion, the swap market has come of age.

Corporate and other borrowers regularly seek to take advantage of fluctuating credit rates by exchanging their fixed-rate interest obligations for other loans at floating rates. Only the interest payments are swapped, not the principal.

INVESTMENT BANKING: How Are Banks Doing?

No longer are swaps an esoteric corporate finance tool that dazzles the uninitiated. In six short years, swaps have developed into one of the largest financial markets around the world.

Swaps have become commonplace, available to almost any company and indispensable to financial institutions competing in today's global arena.

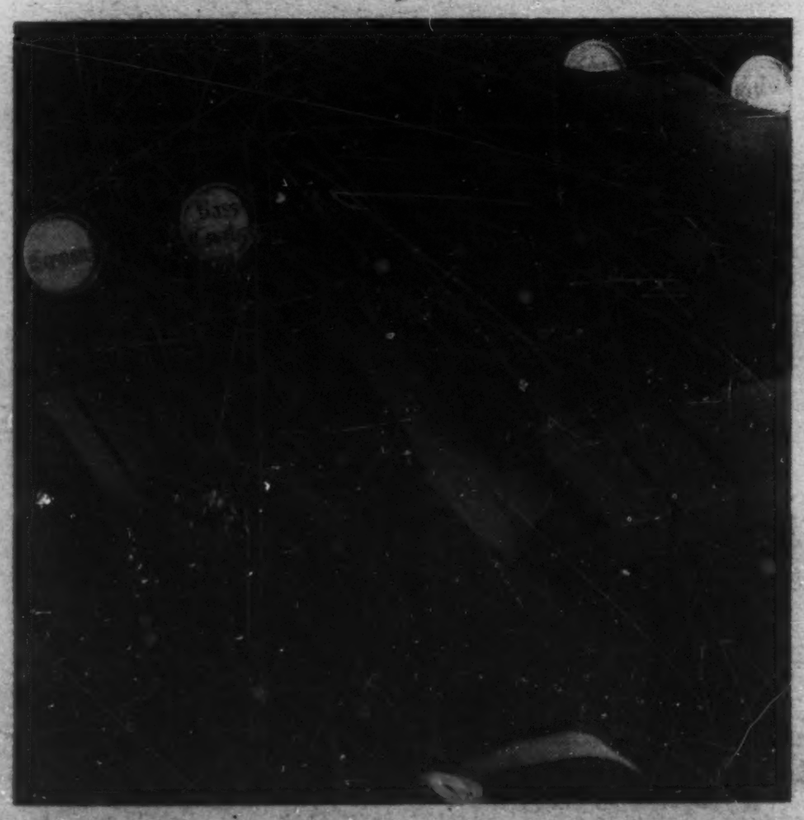
Commercial banks and investment banks compete on equal footing in the swap market. While the competition in swaps is murderous, commercial bankers insist that they have the upper hand.

"U.S. commercial banks dominate in swaps," said Donald Layton, managing director of Manufacturers Hanover Corp. "The Wall Street firms were once neck and neck with the banks, but they have fallen behind."

Swaps provide corporations an efficient way to reduce borrowing costs and manage assets and liabilities. And swaps remain attractive to banks because they provide noninterest income

Bankers: Page 18 ➡

It's easier to pull out all the stops when you're the one who wrote the music.



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April 6, 1988, American Banker

1988 Will Be Another Banner Year for Bank Failures

By IRVINE H. SPRAGUE

MISMANAGEMENT, fraud, greed, and the economy were the dominant reasons for bank failure in 1987, as always; but it is semantics that dictate the count. The Associated Press, the Federal Deposit Insurance Corp., and the *American Banker* all reported that there were 184 bank failures in 1987, the sixth consecutive year that a new and higher record was established.

But according to my calculations there were 203 failures. Others say the total was 193.

The discrepancy comes because I count as a failure any bank that met all the criteria for closing but was kept open through government assistance. I started this method of tabulating failures as FDIC chairman in 1980 when First Pennsylvania failed but was kept open through a 13(c) essentiality assistance transaction and have continued using this count in speeches and writings since.

Mr. Sprague served as chairman or director of the Federal Deposit Insurance Corp. for more than 11 years. During that time, he handled 374 bank failures, more than anyone else in FDIC history.

> Since Penn Square, the question of when to consider a bank a failure has taken on more significance.

After all, those who managed or directed a bank to failure should not escape the stigma of failure. I might note that those associated with Continental Illinois National Bank and Trust Company of Chicago and other bailouts have expressed great distaste over this reasoning.

However, there is some movement toward accepting my analysis.

After 50 years of reporting only on sales and payoffs of closed banks, the FDIC annual report for 1986 compromised with my theory. The table "Disbursements for Protection of Depositors" listed 145 banks — 40 payoffs, 98 sales, and 7 assistance transactions, or bailouts as some call them. It also restated the table to show assistance transactions for the past six years. On another page, the closed bank table listed 138 failures. Similar reports have been made for 1987.

'De Facto Failure'

Another indicator: *The Washington Post* recently described Continental as a de facto failure and quoted the new chairman, Tom Theobald, as saying that the bank at that time had more bad loans than net worth and was ". . . sunk by insolvency."

The stockholders, I guess, can offer the strongest testimony as they hoard worthless paper that officially will become junk when the final accounting of the Continental bailout comes in September of 1989.

A bank can be book insolvent, its liabilities exceeding the assets, or it can be liquidity insolvent, not having sufficient cash to meet its obligations.

Until the Penn Square episode in 1982, I had never really thought about the insolvency finding. After all, our job at the FDIC was not to close a failed bank but to handle a failure after the institution was closed by the primary supervisor.

Penn Square Bank, Oklahoma City, was insolvent, we were certain, but the Comptroller's examination was still underway when the situation climaxed on the Fourth of July weekend.

We wanted to get our people into the bank quickly on Friday night so they could work the long holiday weekend and be prepared for a payoff or a sale when the holiday was over Tuesday morning. Comptroller of the Currency Tod Conover, a member of our FDIC board, sympathized with our need. But he faced the dilemma of how to find the bank book insolvent before the examination was concluded, even through the final result was certain. There was no liquidity insolvency as long as the Fed kept providing money, as they did.

Bank Act No Help for Conover

Mr. Conover found no solace in the National Bank Act which states only that he shall appoint a receiver whenever the Comptroller "shall become satisfied of the insolvency."

Our talks continued inconclusively Friday and Saturday. Finally, Sunday morning, Paul Volcker asked Don Regan to come down. Mr. Regan as Treasury secretary was Mr. Conover's boss. We sat in Mr. Volcker's tiny office and for an hour Mr. Regan listened to us. Then he stood up, smiled and left, saying: "Well, I'm sure you gentlemen will do the right thing." Mr. Conover was on his own.

Finally, the examination had progressed to the point that there was absolutely no question that the bank was insolvent and late Monday night Mr. Conover ordered it closed. Penn Square was a failure by any criteria.

Since then, the question of when to consider a bank as a failure has taken on more significance with the expanded use of 13(c) authority, which allows the FDIC to assist in keeping the bank open on a finding that it is in "imminent" danger of failing and the cost of such a transaction is estimated to be "substantially" lower than the cost of allowing the bank to technically fail.

Last year there were nine such transactions covering 19 banks — that is how I arrived at the 193 or 203 counts, take your choice: 184 plus 9 or 19.

The 13(c) cases ranged from the $3.1 million Falun State Bank in Kansas to the $1.2 billion BancTexas Group of 11 banks.

Although the banks are kept open in a Section 13(c) transaction and the community and customers keep their bank; the end result is roughly the equivalent of a failure as far as management and the stockholders are concerned.

Capital and Management Provisions

Provisions for new management and capital are required for these making a Section 13 application and, according to the FDIC guidelines, "after the assistance . . . a determination that the financial effect upon shareholders and creditors of the bank, or the bank's holding company, approximate the effect on those parties which would have resulted had the assisted bank failed."

In addition to the completed assistance cases in 1987, there were three that were approved in concept but not consummately yearend.

Those who tabulate the numbers will have a field day on these. One is for a single bank in Louisiana, one covers two failing institutions in Alaska, and the third is for the enormously expensive rescue of First City Bancorporation of Texas Inc. which encompasses 62 separate banks.

In an earlier article I suggested that bank managers who are expansion-minded find comfort in the FDIC safety net of Section 13 transactions, but Bill Seidman, now FDIC chairman, reminds me that the safety net is for the depositors, the customers and the community — not stockholders or management. I agree.

Director and officer liability suits are filed by the FDIC against those responsible whether it be de facto or technical failure, if the circumstances warrant. Continental is a good example. In 1987 there were 39 new lawsuits filed and decision was made not to file in 51 cases. It takes time to investigate a failure so most of these actions relate to prior year failures.

Also, in 1987 there were 39 settlements recorded (the same umber as the new suits filed). Recoveries exceeded $59 million.

How the Other Failures Were Handled

To complete the picture of 1987 we should recount how the other 184 cases were handled, the 184 that were failures no matter how you count.

Eleven of these were payoffs by the FDIC, the bank was closed and the insured customers, up to $100,000 per account, were promptly given their money. In another 40 cases the FDIC transferred the accounts to another ban to act as agent for the payoff.

In these 51 cases the uninsured depositors, those with accounts over $100,000, suffer a probable loss, but the fact is that nearly all of these payoffs were for very small institutions with minimal uninsured deposits. Also, in most of the deposit transfer cases the failed bank was replaced in the community with either a new bank or a branch or a nearby institution. Most of the time a large proportion of the assets were sold to the replacement facility.

This leaves the 133 sales, the traditional purchase and assumption transaction in which an existing bank or a newly created one takes over the failed institution. The community, the customers and the depositors, insured and uninsured alike, are made whole. Stockholders and management lose out.

The new twist in 1987 ws the active pursuit of whole bank transactions which were attempted in 52 cases and successfully completely in 19. In a whole bank transaction the purchaser takes over essentially all of the failed bank assets, reducing the FDIC cash outlay and setting up a situation whereby the bank customers can work out their problems with the new owners, not FDIC liquidators.

The other innovation in 1987 was the use in one instance of new bridge bank authority granted by Congress last year. A bridge bank allows the FDIC to operate the failed institution until another solution can be found.

I guess the reality is that there were one heck of a lot of bank failures in 1987, whether the number was 184 or 203, or something else. I recall now, almost with disbelief, my first year on the FDIC board in 1968 when we struggled with just three failures all year, with combined assets of about $25 million.

A prediction: 1988 will be about the same as 1987. ■

Something to Say? We Want to Hear

The *American Banker* welcomes letters, comments, and observations from you, our readers, on issues that interest and are important to you.

We would like our pages to reflect as wide a range of views and opinions as possible — no matter how provocative or controversial. The key goal is to factor your views into our own thinking so that both our newspaper and the executives who read us can do a better job running our organizations.

In addition, we would like to read your responses to the points of view expressed by our columnists and guest writers. Are they on target? Who's right or wrong? What's your own opinion?

Wherever possible, we would like to print your comments. Please direct them to the editor, William Zimmerman, American Banker, One State Street Plaza, New York, N.Y. 10004, and please include a daytime telephone number. Letters may be edited for reasons of space and clarity.

Remember, we need your views to be a true community newspaper.

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April 6, 1988, American Banker

Bankers Cite Edge over Competitors in Swap Market

→ Continued from Page 1

at relatively small risk.

The most common swap, the exchange of floating for fixed interest, is known as a plain-vanilla deal. But swaps can be much more complex if foreign currencies and options are part of the transaction.

Banks make money on swaps through the bid-offer spread. This is the difference between the price a dealer — either an investment banker or a commercial banker — pays to book a swap and the price he must receive at a later date to sell it.

Dealers Aim for 10-Basis-Point Spread

If, for example, a dealer pays a fixed rate of 63 basis points over the five-year Treasury rate to buy a swap, then he will hope to sell it later for 73 basis points over the Treasury note rate to get the 10-basis-point spread that is common in today's market. This bid-offer spread marks what the bank earns on the deal, excluding costs and expenses.

A swap is expressed in terms of notional value, which is roughly equivalent to the principal. A hypothetical swap with a $50 million notional value will earn the dealer $50,000 if the bid-offer spread is 10 basis points.

From the $25 billion of swaps booked in 1982, when the concept originated in the Eurobond market, growth has been phenomenal. Outstandings for interest rate and currency swaps, with maturities of three years or more, are now estimated to exceed $1 trillion, according to Patrick de Saint-Aignan, former chairman of the International Swap Dealers Association and a managing director of Morgan Stanley & Co.

Data from bank call reports show that the 10 largest players in the interest rate swap market had outstandings at the end of 1987 ranging from $18.1 billion to $117.5 billion. Investment banks are not required by the Securities and Exchange Commission to release swap numbers.

Many investment houses consider themselves major factors in the swap market. Only a few continue to act strictly as brokers, arranging swaps but not taking positions in them. Most securities firms operate in the swap market just like commercial banks.

Salomon Brothers Inc. declined to disclose the size of its swap portfolio. "We are a major participant in the market. We are not No. 1, but we are a factor," said Richard F. Leahy, managing director and head of hedging.

Commercial banks maintain that they have an edge in the swap market because of their long history in credit analysis. A bank is able to act as one of the counterparties in a swap transaction. It can afford to hold a deal on its own books for considerable periods, and has the capital base necessary to support a swap portfolio.

"Banks have a tremendous capital capability to take on credit risk," Mr. Layton said. "The securities houses prefer to do a swap when a bond issuance is related."

Commercial bankers also feel that their customers regard them as more secure than investment banks.

"When you have an event like Oct. 19," said Denise Boutross, managing director and head of U.S. dollar swaps for Security Pacific Corp., "people look at it [the markets] very differently. They want to know who is going to be here seven or ten years from now. Banks give a greater sense of security."

The Wall Street Advantage

The Wall Street firms are quick to rebut the commercial banks' claim of dominance. Investment bankers point out that the capital of many of the largest money center swap dealers would be wiped out or severely reduced if they were forced to write down their Third World debt to market price. "Investment banks, on the other hand," said one such banker, "do not have loans to the Third World."

The securities firms have an advantage over the banks in swaps that are tied to publicly issued domestic bonds.

"We can offer an entire package of things, so a swap is usually part of a bond issuance, or we may do something like an asset swap," said Patrick Kelly, a Salomon Brothers director and manager for swap products.

Mr. Kelly estimates that 30% to 40% of the swaps booked by investment banks over the past five years have been tied to bond issues. Investment bankers feel they have an edge because the Glass-Steagall Act prohibits commercial banks from underwriting domestic securities.

With decreased activity in the fixed-income markets, however, about 15% to 25% of the swaps being booked are now linked to bonds, Mr. Kelly said. Salomon has significant swap business related to bonds, he said, declining to provide details.

Corporate treasurers who are active users of interest rate protection see better deals coming from the commercial banks than from the investment banks.

"Commercial banks are much better insulated against rate volatility," said the treasurer of one major U.S. corporation, who requested anonymity. "They are happy just as long as they get the spread they want.

"When absolute interest rates go up, commercial banks can pass along the increase in their cost of funds to their customers. Investment banks are more like brokers. They are willing to tie up their capital only for a short period of time," Mr. Kelly said.

The securities firms say they serve thrifts, insurance companies, and large corporations. Commercial bankers book deals for these groups, but they also arrange swaps for middle-market corporations and customers involved in leveraged buyouts.

Competition has contributed to the stability and liquidity of the swap market. These attributes proved crucial during the October crisis.

"We did see the bid-ask spread widen significantly immediately after the crash," said Renee Ross, a swap trader at Bank of Boston . "But a month later, things were back to normal, which is a good indication of the stability and liquidity of the market."

Household Names Dominate Market

The dominant players are the money center banks and such investment banks as Salomon, Merrill Lynch & Co., and Morgan Stanley & Co. Only a handful of superregional banks — including Marine Midland Bank, Bank of Boston, and NCNB in Charlotte, N.C. — are recognized as substantially active in swaps. The only player new to swaps, industry observers said, is American International Group Inc., an insurance company based in New York.

In 1983, the bid-offer spread on a five-year plain-vanilla deal was 22 basis points. By 1984, it had narrowed to 12 basis points, and a year later it came in at 10 basis points. Since 1985, the spread has held steady.

"It's still a profitable business, even though it's not the bonanza it was at first," said David Gelber, managing director at Chemical Bank in London. "I think we have stabilized our profit margin, and in 1987 those margins held."

As the bid-offer spread has narrowed over the years, industry pundits have questioned whether commercial banks are adequately compensated for their credit exposure. Since swaps are off-balance-sheet items, regulators have little information about these instruments other than gross numbers on notional values. Data on portfolio diversification and pricing remain top secret.

Regulators are becoming increasingly concerned about what would happen in case of a massive swap failure. Commercial bankers balk at any suggestion that they are not pricing adequately for risk.

The exposure a bank takes on when it books a swap is not directly related to the notional value of the swap itself. If one of the counterparties fails, the amount at risk is only what it would cost to replace that swap in the current market, bankers said.

In a five-part series, the *American Banker* looks at banks' progress in investment banking. A report on private placements appeared on Monday and a review of global finance ran Tuesday. The series continues Thursday with a look at how banks are faring as advisers in domestic mergers and acquisitions.

Swap Defaults Are Infrequent

Swap defaults have been rare and losses have been manageable. Bankers feel that, as the market has matured, so has their understanding of how to price for the interest rate and credit risk exposure in a swap.

"Over the last three years, we have a much more refined knowledge of what our exposures are," said Joe Bauman, vice president and head of Chemical Bank's New York swap desk.

Sometime soon, regulators are expected to impose risk-based capital standards requiring bankers to hold capital against all types of assets, including swap portfolios, based on risk. The result, some bankers suggested, will be that banks will have to charge higher fees for swaps to cover the cost of holding the capital. "In fact," said Ms. Boutross of Security Pacific, "we're already seeing widening of bid-offer spreads due to [anticipated] capital adequacy standards."

Investment houses, not subject to risk-based capital requirements, could offer lower prices than the commercial banks on swap deals. Yet commercial bankers don't foresee this type of price war.

"That would be shortsighted for the investment banks," Mr. Bauman said. "The SEC [Securities and Exchange Commission] will follow suit with similar kinds of guidelines. Investment banks that undercut on prices now will find themselves in a lamentable position when the restrictions are imposed, because we know from experience that the regulators won't grandfather in previous exposures."

Customizing Swaps Adds Value

Bankers have learned how to customize the simple swap product to meet the customer's specific needs. This "added value," is what allows bankers to fatten spreads on swaps and pump up profits.

NCNB has identified its niche doing smaller deals for smaller or middle-market companies.

"Our focus is in the Southeast. We have done business with customers within our geographic area," said Mark Whalen, senior vice president of NCNB.

The average swap NCNB has on its books is about $10 million, although it has done swaps for as little as $850,000. While most other banks arrange swaps that are based on the London interbank offered rate, NCNB will do swaps based on the prime lending rate.

"We can get a little wider spread on these," Mr. Whalen said. "Generally there's a little more profitability in these because there's less liquidity."

Interest rate caps and collars provide another way for banks to bring more value to their corporate customers, and thus higher fees.

Caps give the buyer essentially the same kind of protection as swaps against rising interest rates, but do not limit the benefits that may be derived from declining interest rates. The corporation purchases a cap, or an interest rate ceiling, usually by paying an up-front fee or premium. In turn, the corporation receives a guarantee that if interest rates rise above the stipulated ceiling, the bank will pay the difference on the outstanding balances.

While no formal numbers have been compiled on the size of the market, commercial bankers estimate that about $70 billion in caps were written in 1986. In 1987, that number grew to $100 billion.

Like swaps, caps can be written for any term, but a preponderance of caps are for two to three years.

Although the concept of a cap is straightforward, this interest rate protection tool has proved to be complicated for providers to price and to hedge. Consequently, only a handful of banks — whether commercial or investment — are active in the cap market. Those banks that run the largest cap portfolios include Manufacturers Hanover, Citibank, Salomon, Bankers Trust, Chemical Bank, Morgan Guaranty, and Drexel Burnham Lambert, industry observers said.

"Caps are just more complex [than swaps] to handle," said Mr. Layton of Manufacturers Hanover. "You need a research and development group, technology. And because it's more complex, it's more expensive."

If a bank sells an 8% cap to a corporate customer, than the bank must make sure that it has a source of protection in case rates rise above that level. The bank needs a stream of payments to offset its obligation to its customer. This is achieved either by putting on a hedge, frequently done by using options on Eurodollar futures, or by buying a cap from someone else. This trading of caps, in fact, constitutes one of the largest segments of the market.

Unlike the swap market, which is largely dominated by financial institutions such as thrifts and banks, caps are tailor-made for corporations, especially those that have project financing outstanding or leveraged buyouts, where there is considerable floating-rate debt. But bankers have found that a lot of corporate customers have a natural resistance to paying premiums.

"Corporations hate paying premiums," Mr. Layton said. "So we arrange things like a zero-cost collar, where we sell the company a cap and it sells us a floor." The company is willing to give up the benefit if rates decline.

A collar consists of a ceiling and a floor of interest rates. In a collar the bank agrees to pay the difference if interest rates rise above a certain rate, but the corporation must agree to pay the difference to the bank if rates fall below the agreed-upon floor.

"In the U.S. we'll continue to build a more complex structure," said Mr. Layton. "We'll be able to offer risk management on a broader scale and suit a broader array of American companies. At the same time, we'll be impelled by risk-based capital to find mechanisms to reduce the credit risk intensity of the products we sell," he said.

"In the old days," Mr. Layton added, "customers had to fit their needs to whatever products were available. Risk management means doing whatever we can to find the products to meet the customer's needs." ■